



A New Architecture?

At the annual meeting of the IMF and World Bank this fall, finance ministers from a 22-country working group discussed proposals aimed toward the ultimate objective of creating a “new architecture” for the world monetary system. Reports from three working groups were presented with suggestions for enhancing transparency and accountability, establishing standards for strengthening national financial systems, and improving the management of future economic crises. Although fundamental reform of world financial arrangements still is a long way off, it is worthwhile to consider some basic construction principles we can draw on from economic theory.

Whatever their scale and scope, financial markets exist to channel funds from savers and lenders to the most profitable business opportunities. International financial markets relax the constraints that link investment with domestic savings, and provide opportunities for individual investors to globally diversify portfolios. By efficiently allocating capital, a smoothly functioning financial system can be an important element of economic growth and development.

However, the smooth operation of financial markets often is inhibited by problems associated with *asymmetric information*. That is, borrowers generally have better information about the riskiness of their behavior than do their creditors. One particularly nefarious manifestation of this problem is known as *moral hazard*. If a borrower is allowed unrestricted access to funding, there is an incentive to engage in riskier behavior than would be desirable from the lender’s perspective.

To some extent, the very existence of banks and other financial intermediaries reflects efforts to overcome problems of moral hazard. By specializing in originating and maintaining many loans, banks can exploit economies of scale in monitoring borrowers. To further reduce the ability of borrowers to take undue risks, loan

contracts often contain collateral and net worth requirements, credit rationing and other restrictive covenants.

The existence of intermediaries doesn’t entirely solve problems of asymmetric information, however. To the extent that owners and depositors fail to monitor the intermediary itself, incentives for undue risk-taking can simply move up the chain—banks have incentives to make risky bets with their depositors’ funds. This incentive also can be problematic when government support and guarantees are present in the form of features such as deposit insurance and access to a lender-of-last-resort. These government programs have an implicit value, and financial institutions might find it beneficial to engage in risky leverage of that value as well. Consequently, such government programs intended to limit systemic risk usually are accompanied by portfolio and net worth requirements for banks that parallel the restrictive covenants that banks require of their borrowers.

In considering proposals for improving the management of financial crises, the same considerations should be heeded. Although we have seen how capital outflows can have disruptive effects, proposals to restrict the flow of capital are likely to reduce the allocational efficiency of financial markets. On the other hand, arrangements intended to mitigate the disruptive effects of capital flows taking the form of implicit guarantees or “bailouts” raise the potential for risky leverage of the value of those guarantees. That is, moral hazard is just as much of a potential problem in the worldwide economy as it is on smaller scales.

Precautions need to be taken in any proposals for reform to take account of these risks. Nevertheless, it is in the interest of all to make sure that global financial markets are able to operate as efficiently as possible. As proposals for a new architecture are evaluated, it will be important to keep these sound construction principles in mind.

—Michael R. Pakko

